TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Update on Federal Legislation ITEM NUMBER: 8b

ATTACHMENT(S): 1

ACTION: X

MEETING DATE: September 2, 1999

INFORMATION: ___

PRESENTER: Ms. DuCray-Morrill

Attached is a comprehensive report from Hogan & Hartson on issues at the federal level. Ms. DuCray-Morrill will provide a verbal presentation at the meeting.

MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

Washington Monthly Report

Congress approved a mammoth $792 billion 10-year tax cut measure and then blew town for the August recess. President Clinton has promised to veto the bill when it reaches his desk, expected in early September when Congress has returned to session. The President continues to press for his own priorities for using the non-Social Security surplus over the next 10 years -- $328 billion to bolster Medicare's solvency, $74 billion for a new prescription drug benefit, $328 billion for additional defense and discretionary domestic spending, and a $250-300 billion tax cut.

However, the large projected budget surpluses on which both sides are relying so heavily assume that the tight budget caps will stay in place and continue ratcheting down in future years -- a seemingly unrealistic assumption in light of the harsh effects already being felt from this year's spending caps. If instead appropriations levels in the coming years simply were to keep pace with inflation, most of the projected surplus would disappear. Sen. Daniel Patrick Moynihan (D-NY), for his part, has suggested that Congress and the President might want to wait for these 10-year projected budget surpluses to actually materialize before giving them away through permanent changes to the tax code and entitlements.

Contributing to the flux, none of the 13 appropriations measures necessary to keep the Federal government running over the next fiscal year beginning October 1 has been signed into law.

Neither side seems to have an exit strategy at this point. Congressional Republicans seem unsure whether they will negotiate with the Administration to rescue a smaller tax package or simply let the vetoed tax bill sit there in smithereens as a reminder to the affected constituencies to vote Republican in next year's election.

One possibility is some sort of "global" budget negotiation between the Administration and the GOP Congressional leadership. In exchange for flexibility on the tax cuts sought by Congressional Republicans, the Administration and Congressional Democrats are likely to press for additional spending, long-term Medicare solvency, and the proposed new Medicare drug benefit.

Another possibility is that partisan rancor and pre-election positioning will win out, with a continuing resolution being passed to keep the Federal government operating at current levels, and not much more. As Sen. Moynihan observed, "Sometimes gridlock can be a good thing." If a major tax cut and new spending programs fall by the wayside, budget surpluses that do materialize would simply pay down some of the accumulated federal debt.

In any event, September and October are likely to be frenetic months in Washington.

Mandatory Social Security

Prospects are dimming that any serious attention will be paid to substantive Social Security reform before Congress adjourns for the year. There remains a limited possibility that substantive Social Security reform could be taken up as part of a "global" budget summit between the Administration and Congress. However, in any such "global" budget negotiation, the parties likely would have their hands full already with the difficult issues of tax cuts, Medicare, and defense and domestic spending levels. Accordingly, it seems increasingly unlikely that the politically volatile issue Social Security solvency will be dealt with this year, beyond walling off the Social Security trust fund surplus and leaving substantive reform for a future day.

From the standpoint of staving off the possibility of mandatory Social Security coverage for State and local government employees, gridlock and delay on the whole are a good thing. However, with each passing year in which the Social Security solvency issues remains unaddressed, the cost of fixing the problem escalates. This in turn increases the need for new revenues for the trust fund.

In any event, we will remain vigilant for any signs of movement on the Social Security reform issue.

SEC Pay-to-Play Regulations

The Securities and Exchange Commission finally issued on August 4 the long-awaited rules addressing what the SEC characterizes as "pay to play" practices with respect to investment advisors and public plans. The rules are in proposed form, with comments due by November 1, 1999. (An advance copy of the proposed rules was provided to STRS staff for review and distribution in conjunction with the August Board meeting.)

In general, the new rule would prohibit an investment advisor from providing advisory services for compensation to a government client, including a public pension plan, within two years after the advisor, or any of its partners, executive officers, or persons who solicit business on behalf of the advisor, or a political action committee controlled by any of the foregoing, makes a campaign contribution, or solicits a contribution, to a state treasurer, controller, or other elected official whose office is "directly or indirectly responsible for, or can influence the outcome of, the use of an investment advisor by a government entity."

The rule covers contributions to both existing officeholders and candidates for the office. The proposed rule is exceedingly broad in its scope, extending in STRS's case even to Governor Davis because his "office has authority to *appoint* any person who is directly or indirectly responsible for, or can influence the outcome of, the use of an investment advisor." [Emphasis added]. "Contributions " are broadly defined to mean anything of value provided to the official to influence a Federal, State, or local election, including payments toward campaign debts, and transition or inaugural expenses. Contributions cannot be routed through third parties, such as family members, attorneys, or consultants.

Under a *de minimis* exception, contributions of $250 or less are permitted to elected officials and candidates for an office for which the contributor is an eligible voter in an election. (The SEC has asked for comments on whether this *de minimis* threshold should be raised or lowered.)

Finally, the investment advisor must keep certain records regarding the campaign contributions and solicitation activities of the investment advisor, its partners, executive officers, and solicitors.

In making seeking to make the case for Commission action, the preamble to the new rule contains a hodgepodge of mostly press accounts of purported "pay to play" practices. The preamble discusses at some length the litigation between PERS and the State Controller regarding the PERS contribution guidelines, as well as the California press accounts that surrounded the litigation.

STRS is mentioned only once substantively. At the beginning of the preamble, the Commission lays out the problem as follows: "Since the adoption of rule G-37, the Commission has become concerned about other pay to play practices that are not addressed by that rule [the rule affecting broker-dealers in the municipal securities business]; practices which involve public pension plans and other funds." The preamble then elaborates: "We have received reports that the selection of investment advisors, which we regulate under the Advisors Act, may be influenced by political contributions . . .", citing in a footnote as authority for this proposition: "Letter from Thomas Flanigan (former executive director [*sic.*] of the California State Teachers' Retirement System to Arthur Levitt, Chairman, SEC (June 7, 1997), available in File No. S7-19-99 ('[pay to play] potentially places the credibility of many investment operations, either through direct or indirect pressure, in jeopardy'). [[pay to play] reference inserted by SEC in original]. The preamble continues: "There also have been numerous press reports of investment advisors engaging in pay to play practices, some of which report an adverse impact on plans [citing examples unrelated to STRS].” The preamble later notes that allegations of pay to play practices have been reported in at least 17 States.

The preamble asserts that if pay to play practices are a factor in the investment advisor selection process, the public plan can be harmed in several ways. The most qualified advisor may not be selected, leading to “inferior management, diminished returns or even losses.” The plan may pay higher fees “because the advisers must recoup the costs of contributions, or because contract negotiations may not occur at arm’s length.” In addition, the absence of arm’s length negotiations “may enable advisers to obtain greater ancillary benefits, such as ‘soft dollars’, from the advisory relationship, which may be directed for the benefit of the adviser, at the expense of the pension plan, thereby using a fund assets for its own purposes.”

Disclosure is dismissed by the SEC as an ineffective alternative because, as to the trustees, they would be the ones receiving the contributions, and as to plan participants because they are generally unable to act on the information by moving their pension assets to a different plan or reversing a hiring decision regarding an investment adviser.

The broad scope of this new SEC rule already has made it controversial. We will continue to coordinate with the national groups of State and local government entities to monitor reaction and follow-up activities planned by these groups. We will await direction from the Board and STRS staff for any broader effort on this issue.

Pension Provisions of Tax Cut Legislation

With the graying of the Baby Boom generation, retirement security has become a theme that resonates with a substantial segment of the electorate and awaiting the Presidential veto. As a result, retirement security has risen to a prominent place on the tax legislative agenda.

The massive tax cut package adopted by Congress and awaiting the Presidential veto, known as the “Taxpayer Refund and Relief Act of 1999”, adopts the furthest-reaching changes to the pension tax rules in years. In the face of the expected Presidential veto of the overall tax package, it remains to be seen how many of the broader changes in the pension rules would survive in a subsequent narrower tax package negotiated by the Administration and Congress. However, public plans did quite well with a series of provisions to enhance portability among public plans and to ease various limits and restrictions under current law. These public plan provisions are largely noncontroversial and are not costly, and hence would stand a good chance of being included in any narrower tax package developed later this year.

The Act substantially liberalizes the current law limits on contributions and benefits under pension plans. The Code section 415 dollar limit on annual benefits under a defined benefit plan would be increased to $160,000. The dollar limit on annual contributions to a defined contribution plan would be increased to $40,000. The compensation-based limit under a defined contribution plan (including a section 403(b) arrangement)) and a section 457 plan would be increased to 100 percent of compensation. The amount of compensation that may be taken into account under Code section 401(a)(17) in computing benefits would be increased to $200,000 (and indexed).

For section 403(b) arrangements (and section 401(k) plans), the annual limit on elective deferrals would be phased upward in $1,000 increments each year to reach $15,000 per year in 2005 (and indexed thereafter). The current law exclusion allowance applicable to section 403(b) contributions would be repealed in favor of applying the overall contribution limits applicable to defined contribution plans generally. The current law "coordination" rule which reduces permissible deferrals under a section 457 deferred compensation arrangement on a dollar-for-dollar basis by the participant's deferrals under a section 403(b) arrangement would be repealed. In addition, the participant could elect to have deferrals under a section 403(b) plan treated as an after-tax contribution, similar to the "Roth IRA" approach, the earnings from which later could be withdrawn tax-free.

For section 457 deferred compensation plans, the annual limit on deferrals would be phased upwards in $1,000 annual increments to reach $15,000 in the year 2005 (and indexed thereafter). As noted above, the current law offset of section 457 deferrals by section 403(b) deferrals would be repealed. The tax treatment of a section 457 plan domestic relations order distribution in the case of a divorce would be clarified to provide that the recipient of the distribution bears the tax, rather than the plan participant.

The measure permits so-called "catch-up contributions" for older workers by increasing for workers aged 50 and older the dollar limit on deferrals under section 403(b), section 457, and section 401(k) plans. To permit these "catch up contributions" the dollar limit for such "older workers" would be phased upwards by 10 percent each year during years 2001 through 2005, up to a maximum of 50 percent of the otherwise applicable dollar limit.

The coalition efforts of the public plan community were quite successful in having a series of portability provisions included in the legislation. There would be full portability between tax-qualified defined benefit and defined contribution plans, section 403(b) arrangements, and governmental section 457 plans, when employees change jobs. Rollovers from section 403(b) arrangements and section 457 plans could be used to purchase permissive service credit under a defined benefit plan or to make a redeposit of previously-refunded contributions from the defined benefit plan.

In addition, rollovers also would be allowed from IRAs into defined benefit and defined contribution plans, section 403(b) arrangements, and governmental section 457 plans. Rollovers of *after-tax* contributions would be permitted for the first time, between qualified plans and from a qualified plan to an IRA. For rollovers into section 457 plans from qualified plans, separate accounting and tracking would be required, with the Code section 72(t) excise tax being triggered on any premature lump sum distribution. Distributions from section 457 plans would be given the same flexibility and direct rollover eligibility as section 401(k) plans have under current law, subject to similar disclosure, reporting, and withholding obligations.

Finally, we worked with the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR) to fashion a carve-out for governmental plans from a provision that imposes on all defined benefit plans a new disclosure requirement in the case of benefit reductions. Under one version of this provision, a "benefit reduction" would have been broadly defined to include elimination or reduction of an early retirement subsidy or retirement-type subsidy or an amendment that required the participant to choose between two or more benefit formulas.

As originally drafted by the House and Senate, this disclosure provision would have applied to all defined benefit plans, including governmental plans, and would have imposed ERISA-type disclosure requirements on governmental plans for the first time. As the result of the carve-out for governmental plans included in the final House-Senate Conference agreement, this provision will not apply to State and local plans.

Finally, the legislation makes various simplifying changes to the minimum distribution rules, as well as a variety of other technical changes.

Elk Hills Compensation

We are continuing to prepare for the House-Senate Conference which will be necessary to meld the House Interior Appropriations bill -- which includes the $36 million Elk Hills appropriation -- and the Senate Interior Appropriations bill which does not. The full Senate took up, but did not complete action, on the Interior Appropriations measure prior to recessing until September.

We have begun actively working on the White House staff , whose efforts proved so pivotal in last year's years high-level negotiations between the Administration and the Congressional leadership over appropriations. We will be coordinating with Rep. Thomas in particular on the House side and Sen. Feinstein, who serves on the Senate Interior Appropriations Subcommittee, on the Senate side.

Continuing expressions of interest to the President and the Vice President by STRS retiree groups and other STRS constituent groups will be very helpful. The State Attorney General has written strong letters of support for the Elk Hills appropriation to the President, the Vice President, the Senate Interior Appropriations Subcommittee leadership, and Senator Feinstein. A letter from the Governor to the President would be quite useful.

As you know, the President's staff has a long history of active support for our efforts, dating back to when Leon Panetta was the President's Chief of Staff and more recently when the Elk Hills appropriation was on the list of key appropriations items that Erskine Bowles (the then-Chief of Staff) and John Podesta (the current Chief of Staff) took to the Hill in negotiating last year's omnibus appropriations package with the Congressional leadership. As the result of these efforts and the efforts by Rep. Thomas and our congressional supporters, the $36 million Elk Hills appropriation for last year was included in the final version of the appropriations legislation even though the House and Senate Interior Appropriations Subcommittee Chairmen had declined to put it in either the House or Senate measures. Hopefully we will not have to conjure up this level of magic the second time around.

John S. Stanton

August 9, 1999